



Memorandum

California Public Employees' Retirement System

Date: August 14, 2006

To: Members of the Investment Committee

From: Christianna Wood, Senior Investment Officer, Global Equity
Dennis Johnson, Senior Portfolio Manager, Corporate Governance

Subject: Stock Option Backdating Update

Executive Summary

At the June 19, 2006 meeting of the Investment Committee, staff was directed to provide the Committee with an update on CalPERS' option backdating company engagement initiative. Staff was also directed to develop and seek approval by the Investment Policy Sub-Committee, a policy statement pertaining to the backdating of employee stock options. An Agenda Item was presented at the August 11, 2006 meeting of the Investment Policy Sub-Committee.

This Agenda Item is in response to the Investment Committee's direction to provide the Committee with an update on CalPERS' option backdating company engagement initiative. To date, initial engagement letters have been sent to 40 portfolio companies on the risk they pose to CalPERS' investment portfolio for the allegation of backdating stock options. Staff has received both written and verbal responses to the initial engagement letter from 18 portfolio companies. The next update on this subject to the Investment Committee will be during the next Executive Compensation Strategic Plan Update.

Background

With guidance from the Corporate Governance Internal Staff Working Group and input from the compensation consulting industry, staff developed and implemented an initiative to engage portfolio companies that have received a notice of inquiry from the Securities and Exchange Commission (SEC) about backdating stock options.

Through the use of both internal research and external resources, staff has concluded that the problems associated with the backdating of stock options are very broad. These problems generally fall into three categories:

- Inadequate disclosure and transparency of the details for stock option plans for both directors and employees of a company.
- Insufficient oversight of the stock option plan by the Board of Directors.
- Poor internal controls and audit practices.

The consequences for shareowners resulting from problems associated with the backdating of stock options include but are not limited to a decline in the company's stock price, restatement of historical financial results, and related management turnover.

Inadequate Disclosure and Transparency

Inadequate disclosure and transparency about the administration and methodologies that govern a company's stock option plan raise the risk of a restatement of their financial results. The risk of a restatement of financial results comes from an erroneous accounting by the company of after-tax employee compensation expense. Accounting standards allowed companies to avoid taxes on the stock option grants awarded when the market price equaled the strike price for the stock option on the date the stock option was granted. Given that most of the allegations involve employees using a strike price lower than the stock option's grant price, under these circumstances accounting standards require the option to be designated as a "discount" stock option grant and requires the company to recognize the tax liability for the difference between the stock option grant price and the lower incorrect strike price.

Receipt of a "discounted" stock option also creates a potential tax problem for the employee. Accounting standards require the employee to recognize the discounted value of the stock option as deferred compensation. This is not the case when the employee receives a stock option grant whereby the market price equals the option's strike price on the date of the stock option grant.

When the company reverses the incorrect award of a "discounted" stock option and replaces it with a stock option where the market price equals the stock option strike price at the time of the stock option grant, this could possibly reduce the employee's potential profit. One additional outcome may be that the company decides to make the employee "whole" for this reduction in the profit of the stock option.

Lack of Board Oversight

The Board of Directors generally approves a pool of stock options with specific parameters specifying the stock option grant date, grant price and quantity. The stock option pool is usually allocated by the Board to be part of the executive management team's compensation and also for distribution to rank and file employees through the delegation of authority to the Chief Executive Officer.

Given the formation and findings by independent committees of the Board investigating the company's stock option plan, disclosure of financial statement restatements, and the surprise reaction to the allegations by directors, it appears that reviews, checks and balances by the Compensation Committee of the Board and the entire Board of Directors were inadequate.

Poor Internal Controls and Audit Practices

The backdating of options raises concern about internal controls and effective option plan administration. The problem of option backdating also raises concerns about the effectiveness of the external auditor, the Board's oversight of the external auditor's report and the effectiveness of the Audit Committee of the Board of Directors.

Portfolio Company Engagements

On June 7, 2006, 24 portfolio companies were notified of CalPERS' concern about the risk their company poses to CalPERS' investment portfolio given the allegations of backdating stock options. An example of the initial engagement letter is contained in Attachment 1. Not only does the initial engagement letter identify CalPERS' cause for concern, but also contains several recommendations. Recommendations provided by CalPERS to portfolio companies are:

- Conduct an independent investigation into the allegation of employee stock option backdating.
- Publicly disclose all findings resulting from both internal and external investigations, regardless of the outcome.
- Develop and disclose in public financial statements and proxy statements a new Board of Directors' policy for the determination of all option grant dates.
- Adopt and implement a strong policy that requires the Board of Directors through the Compensation Committee to conduct an audit of the Executive Compensation Plan Administrator for compliance with Board approved directives pertaining to executive compensation.

- Refrain from using any company resources to satisfy the tax and legal liability for executives implicated for wrongdoing related to the backdating of options.
- Commit to have the external auditor for the company ratified by shareowners on an annual basis.
- Take steps to ensure that the Board evaluation, Committee evaluation and individual director evaluation process includes substantial and meaningful oversight by individual directors and the Board of Directors as a whole.

Initial engagement letters have been provided to 16 additional portfolio companies since the option backdating company engagement initiative began on June 7, 2006. This brings the total number of companies to 40 that staff is engaging for option backdating (Attachment 2).

To date 18 companies have responded to the initial engagement letter. Of the total responses received to the initial engagement letter, 15 companies provided written responses and 3 were telephone conversations.

Next Steps

Staff is contacting those companies that have yet to provide a response to the initial engagement letter. Given the complexity of the matter, the time required for the independent special committee of a Board to conduct its investigation and the unknown time frame for the SEC to complete its inquiries, this process could take some time. Staff will provide another update on the option backdating company engagement initiative to the Investment Committee during the next Executive Compensation Strategic Plan Update.



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June 7, 2006

Via Overnight Courier

Company ABC
Address

Dear Ms/Mr. X:

The California Public Employees' Retirement System (CalPERS) is the largest U.S. public pension fund with over \$200 billion in total assets. It is with the greatest concern as an institutional shareowner of X shares of Company ABC that I write you today regarding the serious threats to the credibility, governance and performance of Company ABC. Recently published allegations of the company's management backdating option grants prompting an investigation by the Securities and Exchange Commission poses a serious threat to the creation and sustainability of long-term value for shareowners.

The implications of these allegations are:

- Lack of oversight by the Board of Directors
- Weak internal controls
- Weak internal and external audit practices
- Poor accounting
- Significant income tax consequences for persons implicated for backdating options
- Problems with the Executive Compensation Plan Administrator

As the Board of Directors works to identify and correct problems resulting from these allegations and the Securities and Exchange Commission investigation, CalPERS recommends that Company ABC directors to do the following:

- Conduct an independent investigation into the allegation of employee stock option backdating.
- Publicly disclose all findings resulting from both internal and external investigations, regardless of the outcome.

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- Develop and disclose in public financial statements and proxy statements a new Board of Directors' policy for the determination of all option grant dates.
- Adopt and implement a strong policy that requires the Board of Directors through the Compensation Committee to conduct an audit of the Executive Compensation Plan Administrator for compliance with Board approved directives pertaining to executive compensation.
- Refrain from using any company resources to satisfy the tax and legal liability for executives implicated for wrongdoing related to the backdating of options.
- Commit to have the external auditor for the company ratified by shareowners on an annual basis.
- Take steps to ensure that the Board evaluation, Committee evaluation and individual director evaluation process includes substantial and meaningful oversight by individual directors and the Board of Directors as a whole.

Please contact Dennis Johnson, Senior Portfolio Manager Corporate Governance at (916) 795-2731 to provide CalPERS the Board of Directors' response to each of our seven recommendations.

Sincerely,

A handwritten signature in black ink, appearing to read 'C. Wood', is positioned above the printed name and title.

Christianna Wood
Senior Investment Officer Global Equity

Cc: Executive Staff
Russell Read, Chief Investment Officer
Dennis Johnson, Senior Portfolio Manager Corporate Governance

Options Backdating			
	<i>Company Name</i>	<i>GICS Sector</i>	<i>Market Cap in millions of dollars as of 6/30/06</i>
1	Home Depot	Consumer Discretionary	\$ 75,910.59
2	Barnes & Noble, Inc.	Consumer Discretionary	\$ 2,190.75
3	Meade Instruments	Consumer Discretionary	\$ 49.01
4	Delta Petroleum	Energy	\$ 875.45
5	United Healthcare Group	Health Care	\$ 60,139.54
6	Caremark	Health Care	\$ 21,976.00
7	Sepracor	Health Care	\$ 5,969.30
8	Medarex	Health Care	\$ 1,077.53
9	Cyberonics	Health Care	\$ 536.39
10	Monster Worldwide	Industrials	\$ 5,463.55
11	Stolt- Nielsen, SA	Industrials	1328.65
12	Broadcom	Information Technology	\$ 16,538.94
13	Analog Devices	Information Technology	\$ 11,607.65
14	Intuit Corp.	Information Technology	\$ 10,321.59
15	Maxim Integrated	Information Technology	\$ 10,297.35
16	Linear Tech	Information Technology	\$ 10,276.00
17	Computer Sciences	Information Technology	\$ 9,092.86
18	KLA Tencor	Information Technology	\$ 8,276.01
19	Xilinx	Information Technology	\$ 7,760.30
20	Altera Corp	Information Technology	\$ 6,307.80
21	Affiliated Computer Services	Information Technology	\$ 6,119.50
22	Verisign	Information Technology	\$ 5,671.81
23	Jabil Circuits	Information Technology	\$ 5,401.60
24	Comverse Technology	Information Technology	\$ 3,990.79
25	McAfee	Information Technology	\$ 3,864.73
26	F5 Networks Inc.	Information Technology	\$ 2,159.95
27	RSA Security	Information Technology	\$ 1,971.04
28	Zoran	Information Technology	\$ 1,137.07
29	Sycamore Networks	Information Technology	\$ 1,131.62
30	Macrovision	Information Technology	\$ 1,112.71
31	Openwave Systems	Information Technology	\$ 1,089.12
32	Trident Microsystems	Information Technology	\$ 1,083.82
33	Semtech	Information Technology	\$ 1,050.43
34	Brooks Automation	Information Technology	\$ 879.62
35	Take-Two Interactive Corp.	Information Technology	\$ 784.61
36	Power Integration	Information Technology	\$ 516.50
37	Safenet	Information Technology	\$ 426.01
38	Asyst Tech	Information Technology	\$ 364.78
39	Vitesse Semiconductor	Information Technology	\$ 315.65
40	American Tower	Telecommunication Services	\$ 13,080.60